

AGENCY PRINCIPLES AND LARGE BLOCK SHAREHOLDERS

Deborah A. DeMott*

INTRODUCTION

Events over the past decade demonstrate that Berkshire Hathaway's investment performance enjoys an avid following and that its investment decisions are themselves influential. Berkshire is a holding company with insurance subsidiaries whose portfolio investments include large blocks of equity securities issued by well-known public companies. These holdings, as of March 1996, included significant equity stakes in American Express Co., Coca-Cola Co., Washington Post Co., and Salomon Inc.¹ A few examples of the keenness of investor interest in Berkshire's activities should suffice. In October 1995, Berkshire decided to redeem a portion of the preferred stock it held in Salomon, Inc. rather than convert it into common stock. After the announcement, Salomon's stock dropped by \$1.75 from its prior day's close, a decrease in share value of 4.4% despite Salomon's prior announcement of strong quarterly earnings.² More recently, Berkshire created a sec-

* Professor of Law, Duke University School of Law. I am grateful to Michael Bradley, James D. Cox, and Ernst Maug for their comments on an early draft of this Article. I also benefitted from the oral comments of Warren Buffett, Edmund Kitch and Charles Munger following my oral presentation of the Article on October 27, 1996.

¹ See BERKSHIRE HATHAWAY INC., AN OWNER'S MANUAL (inside front cover) (1996).

² See Anita Raghavan, *Buffett's Planned Salomon Sale Hits Stock*, WALL ST. J., Oct. 20, 1995, at C1. The redemption reduced Berkshire's equity stake in Salomon from 20.4% to 17.6%, shortly after Salomon announced a significant improvement in its third-quarter net income compared with the prior year. In third-quarter 1995, Salomon had \$268 million in net income, contrasting with a \$104 million loss in third-quarter 1994; the third-quarter 1995 results followed losses in four of the five preceding quarters. The redemption required a cash outlay by Salomon of \$140 million, while Salomon's common stock lost \$186.2 million of its market value following the announcement. See *id.*

Even a mistaken belief about Berkshire's decisions can be influential. Shares of Wells Fargo & Co. fell sharply in August 1997 due to the mistaken belief that Berkshire had sold its entire holding, reducing Wells Fargo's market value by \$1.3 billion within an hour's trading time. See Floyd Norris, *A Misrepresentation of a Buffett Filing Stings Wells Fargo*, N.Y. TIMES, Aug. 22, 1997, at A1. In fact, market followers of Berkshire misinterpreted a quarterly report it filed with the SEC that omitted its Wells Fargo stake, not because Berkshire sold the investment, but because Berkshire and a few other firms have the SEC's consent to file a confidential report disclosing various of their holdings. When the error was discovered, Wells Fargo's stock recovered a bit, but not completely, while the price of Berkshire's two classes of stock declined. See *id.* at C6.

ond class of common shares—structured to trade at a much lower price than its prior shares—expressly to vitiate the appeal to investors of unit investment trusts that would invest in Berkshire common stock and in companies included in its investment portfolio.³ The “Baby Berkshires” found their market without an active solicitation of buyers by their underwriter’s insurance analyst and without any “road show” to promote the issue.⁴ Such intensity of

Part of the interest in these incidents stems from the fact that equity holdings in U.S. public capital markets are generally dispersed. Unlike Berkshire Hathaway, many institutional holders do not own such large blocks of stock in any particular company. In the U.K. market, in which institutional ownership is both more predominant and more concentrated, knowledge of an institution’s impending sale is more likely to trigger a sell-off, especially if other institutions believe that the selling institution had nonpublic information about the company or that the effect of its sale would be to flood the market. See Bernard S. Black & John C. Coffee, Jr., *Hail Britannia: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2062 (1994). The reaction to Berkshire’s announcement is thus indicative of the strength of its market following.

³ For a description of events leading to Berkshire’s recapitalization, see Anita Raghavan, *Salomon’s ‘Baby Share’ Underwriting for Berkshire Causes Industry Tremors*, WALL ST. J., May 9, 1996, at A4. The recapitalization designated Berkshire’s original common shares as Class A convertible, at the holder’s option, to 30 shares of the new class, designated Class “B.” Class B stock is not convertible into Class A and has, per share, 1/30 of the dividend and liquidation rights, and 1/200 of the voting power of Class A. Berkshire coupled the recapitalization with a planned public offering of Class B shares for at least \$100 million. As it happened, the size of the public offering greatly exceeded this amount. See Raghavan, *supra*. The recapitalization enabled investors to buy into Berkshire directly and without bearing an additional layer of management fees and marketing costs. It also facilitated inter vivos gifts and testamentary dispositions by its current holders. Although Class B’s voting rights are inferior to its economic rights, its creation does not appear relevant to control issues within Berkshire. Both before and after the transaction, Warren Buffett and Charles Munger were Berkshire’s controlling shareholders.

Formally, the creation of Class B represents an attempt to reduce obvious free riding on Berkshire’s effort and success in investment selection. The existence of Class B enables Berkshire to attract additional equity capital on the basis of investors’ expectations that its future prospects are good. It is, of course, a separate question how successful Berkshire’s management will be in investing the proceeds of the public offering of Class B shares. By 1994, Berkshire’s net worth had risen to \$11.9 billion, compared to \$22 million when its current management assumed control. See Lawrence A. Cunningham, Compilation, *The Essays of Warren Buffett: Lessons for Corporate America*, 19 CARDOZO L. REV. 1, 207-08 (1997) [hereinafter *Buffett Essays*]. Intuition confirms the plausibility of Mr. Buffett’s observation that “[a] fat wallet . . . is the enemy of superior investment results.” *Id.* at 207.

Another form of free riding occurs when a block holder’s relationship with a portfolio company has the consequence of enhancing its value for all shareholders in the portfolio company. The large block holder would incur costs were it to monitor its portfolio investments carefully and intervene when circumstances require action to avert loss in a portfolio company’s value. Other shareholders would benefit without bearing a proportionate share of the block holder’s costs, which in the event of intervention could include the legal consequences of exercising operational control. For a further discussion of this form of free riding, see *infra* text accompanying note 51.

⁴ See Raghavan, *supra* note 3, at A4. Berkshire’s underwriter, Salomon Inc, distributed in the vicinity of 517,500 shares of Berkshire Class B, priced at \$1100 apiece, results that would generate gross proceeds of \$569 million. For its services, Salomon received an

interest and degree of market influence are far from typical. Anomalous though it may be, Berkshire's experience invites inquiry into the legal duties applicable to large block shareholders.

The consequences of a large block shareholder's decisions are not limited to its own interests. Sheer size, especially when coupled with evident influence on other investors, may suggest that large block holders should, as investors, be subject to norms more exacting than those applicable to less substantial investors. In this Article I examine the legal norms that currently apply to large block holders. As the Article's title intimates, I also consider the consequences were the law to characterize large block holders as agents of their fellow shareholders. These are, I argue, questions that are germane to relational investing. An initial observation is that large block holders are in a position to benefit, through their share holdings, in unique ways not available to other shareholders. Are large block holders under a duty to abjure such advantages? Is it improper for a large block shareholder to receive information not available to other shareholders or to sell or buy stock on uniquely advantageous terms? My analysis contrasts the answers to such questions under current law with the likely answers if large block holders were to be treated as agents of other shareholders.

My purpose in undertaking this exercise is to explore whether optimism respecting relational investing can be grounded, even hypothetically, in the terms of a relational bargain that is plausible and stable. This entails an examination of the legal character of the relationships among shareholders, including the duties shareholders owe to each other, when the picture includes a shareholder that holds a large block of shares and is thus in a position to monitor—and perhaps influence, if not necessarily control—decisions made by the corporation's management. As we shall see, present law does not oblige a large block holder to act as an agent on behalf of other shareholders—that is, to take action that furthers other shareholders' interests in preference to its own. One reason is that the block holder that diligently monitors a company's management incurs costs from which all shareholders benefit without bearing a proportionate share of the monitor's costs. Additionally, by hold-

underwriting fee of \$7.8 million, about 1.5% of the offering's proceeds. In contrast, the average fee for an initial public offering is 7.3% of proceeds and the average fee for an add-on offering for an already-public company is about 5.7% of proceeds. Industry sources discounted the precedential significance of the Berkshire deal on the basis that Mr. Buffett's "name alone is enough to sell a stock offering." *Id.* The number of Class B shares sold was the result of Mr. Buffett's willingness to sell as many as necessary to satisfy investor orders.

ing an undiversified position, a large block holder foregoes opportunities to diversify its investment. Even were the law to deem large block holders to be agents, free riding by other shareholders would continue; the block holder would remain unable, through generally acceptable conduct, to fully capture the net economic benefits generated by its efforts. The presumed relationship underlying relational investing is, thus, intrinsically unstable, suggesting optimism that increasing relational investing will benefit all shareholders may be unfounded.

I. CURRENT LEGAL NORMS

The terminology of agency is used by several disparate academic disciplines. Relevant for present purposes are the legal definition of agency and the legal consequences of an agent-principal relationship, which coincide with and differ from concepts of agency in other academic disciplines.⁵ In legal terminology, an agent acts on behalf of its principal in a fiduciary relationship, subject to the principal's right to control the agent.⁶ This definition illustrates, as an initial matter, that large block holders are not the other shareholders' agents, at least as present law defines agency and its consequences. The absence of any formal right of fellow shareholders to control a large block holder removes large block holders from the definition's reach. Additionally, although a large block holder may benefit other shareholders by monitoring and advising a portfolio company's management, large block holders, at present, do not expressly undertake to provide such services. Other legal doctrines, however, supplement the formal definition of agency. One who enlists others' trust and confidence and who undertakes to act on behalf of others is, like an agent, obliged to act to further the others' interests.⁷ Moreover, some large block

⁵ See, e.g., HANNA F. PITKIN, *THE CONCEPT OF REPRESENTATION* (1967) (analyzing meaning and significance of representation of one person by another in political philosophy).

⁶ See RESTATEMENT (SECOND) OF AGENCY § 1 (1958).

⁷ Investment advisors, for example, are subject to fiduciary duties. See *In re Arleen W. Hughes*, 48-5 Fed. Sec. L. Rep. (CCH) ¶ 75,918 (Feb. 18, 1948), *aff'd*, 174 F.2d 969 (D.C. Cir. 1949). Outside a formal advisory context, the reposing of trust and confidence in another, standing alone, rarely triggers fiduciary obligation in a commercial setting. Compare *Rajala v. Allied Corp.*, 919 F.2d 610, 623 (10th Cir. 1990) (holding that under Kansas law, to establish fiduciary duty in a commercial context on the basis of reposing trust and confidence, the party seeking the imposition of duty must show that the other party consciously assumed such duty) with *Kutz v. Cargill, Inc.*, 793 S.W.2d 622, 625 (Mo. Ct. App. 1990) (holding that evidence must show one party placed trust in another because latter party influenced and broke will power of trusting one); *Burger King Corp. v. Austin*, 805 F. Supp. 1007, 1021 (S.D. Fla. 1992) (holding that under Georgia law, a court may

holders are in a position to exercise a controlling influence over the management or policies of the corporation—a fact that implicates the normative consequences of possessing or exercising control. Although substantial legal consequences follow from the exercise of control, only rarely does the law impose a duty to exercise it.

Legal norms presently applicable to shareholding contemplate actors free to act in individualized ways, each attempting to advance its own interests as best it can. Shareholders conventionally are not each others' agents. They owe no duty to one another in determining whether to buy or sell stock,⁸ or in exercising their rights to participate in corporate governance by voting to elect directors or to approve or disapprove fundamental transactions.⁹ Moreover, many legal norms applicable in this field define roles and reward actors whose conduct does not venture beyond their delimited role. Equity investors and creditors assume additional legal duties and concomitant liabilities if they act outside their formally defined roles. In particular, significant legal consequences follow for equity investors and creditors who exercise operational control within a corporation. A shareholder that exercises control owes fiduciary duties, defined in context-specific fashion, to the corporation and its noncontrolling shareholders.¹⁰ Equity holders and creditors who exercise operational control jeopardize their in-

impose fiduciary duties when facts are "particularly egregious") and *Williams v. Dresser Indus., Inc.*, 795 F. Supp. 1144 (N.D. Ga. 1992) (applying Georgia law and denying defendant franchisor's motion to dismiss because it breached the duty of disclosure in negotiations over terms of franchisee's renewal contract when it failed to disclose imminent joint venture with franchisee's major competitor but induced additional major investment by franchisee).

⁸ A shareholder who holds stock as a fiduciary owes duties to the beneficiary of the fiduciary relationship.

⁹ On occasion, Berkshire has imposed limits on the voting rights that it would ordinarily exercise. In connection with its 1985 purchase of 3 million shares of Capital Cities/ABC, Inc., Berkshire authorized Capital Cities's CEO to vote Berkshire's shares "for an extended period." *Buffett Essays, supra* note 3, at 88. Berkshire also entered into unspecified restrictions on its right to sell its Capital Cities block "to make sure that our block does not get sold to anyone who is a large holder (or intends to become a large holder) without the approval of management." *Id.* Berkshire had prior similar agreements with GEICO and Washington Post, justifying them all as conducive to managerial focus on running the business and creating long-term shareholder value, immune to the lure of "revolving door capitalists" who might try to place the company in play. Key to this strategy is Berkshire's confidence in the incumbent management of its portfolio companies. *See id.*

¹⁰ For a recent illustration, see *Thorpe v. CERBCO, Inc.*, 676 A.2d 436, 442 (Del. 1996) (holding that the duty owed by controlling shareholder "will vary according to the role being played by that person and the stage of the transaction at which the power is employed").

sulation from liability incurred by the corporation.¹¹ Controlling creditors in an insolvent corporation are, additionally, at risk of being treated as equity owners for purposes of bankruptcy law.¹² Moreover, the law does not oblige an equity investor to assume an additional role; a shareholder need not exercise operational control even when the holder is able to do so.¹³ Likewise, controlling shareholders are not obliged to initiate any fundamental corporate transactions from which all shareholders would benefit.¹⁴

Basic aspects of the law of agency reinforce the narrow cast of shareholders' and creditors' formally drawn roles by protecting shareholders and creditors who do not act outside those roles. A corporation is not the agent of its majority shareholder, or of its sole shareholder for that matter, merely because the shareholder owns all or a majority of the corporation's voting equity securities.¹⁵ A shareholder's exercise of its voting rights to elect directors, therefore, does not in itself make the directors the

¹¹ For a discussion of the role of domination in cases in which the plaintiff seeks to pierce the corporate veil and impose liability on shareholders, see 1 JAMES D. COX ET AL., CORPORATIONS § 7.10 (1995). "A creditor who assumes control of his debtor's business for the mutual benefit of himself and his debtor, may become a principal" and thus become liable for the debtor's acts and transactions in connection with the business. RESTATEMENT OF AGENCY, *supra* note 6, § 14o; *see also* A. Gay Jensen Farms Co. v. Cargill, Inc., 309 N.W.2d 285 (Minn. 1981) (finding lender to be a principal within definition set forth in RESTATEMENT OF AGENCY, *supra* note 6, § 14o).

¹² For a discussion of equitable subordination in bankruptcy, see ROBERT CHARLES CLARK, CORPORATE LAW § 2.3 (1986).

¹³ *See In re Silicone Gel Breast Implant Products Liability Litig.*, 837 F. Supp. 1128 (N.D. Ala. 1993). The common law imposes such a duty only when a "special relationship" exists between the actor and another person that imposes a duty on the actor to control the other person's conduct. *See* RESTATEMENT (SECOND) OF TORTS § 315 (1965). "Special relationships" include those between parents and children, and employers and employees. *See id.* §§ 316-17. In contrast, numerous statutes effectively broaden the liability of controlling shareholders. *See, e.g.*, Securities Exchange Act of 1934, 15 U.S.C. § 78t (1994) (liability of controlling persons).

¹⁴ *See Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464, 476 (Cal. 1969) (controlling shareholder has no duty to make market for and facilitate trading in corporation's stock).

¹⁵ *See* RESTATEMENT OF AGENCY, *supra* note 6, § 14M. This principle has many implications. *See, e.g.*, *Foremost-McKesson, Inc. v. Islamic Republic of Iran*, 905 F.2d 438, 448 (D.C. Cir. 1990) (majority shareholding and majority control of board of directors insufficient to establish principal-agent relationship for purposes of Foreign Sovereign Immunities Act; court declines to assume that official of state entity who serves on business corporation's board will always act to serve sovereign's interests).

Robert Thompson observes that it is perplexing that courts are reluctant "to hold a corporate parent liable for the obligations of its subsidiaries when the parent possesses both the opportunity to control and the potential to share in residual earnings of a subsidiary." Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1, 5 (1994). One possible explanation is the prospect that a subsidiary not actively dominated by its parent is subject to other constraining forces, such as the credit markets. Thus, imposing additional

shareholder's agents, nor does it create an agency relationship between that shareholder and the corporation.

It is interesting that the impact of these long-established propositions has not, with a few implicit exceptions,¹⁶ been acknowledged in discussions of relational investing. However they define the term,¹⁷ proponents of relational investing stress its promise to enhance value for all of a corporation's shareholders. An unsurprising adjunct to this perspective would be advocacy for lowering whatever regulatory barriers appear to impede the expansion of relational investing.¹⁸ Recast as a relational investor, a large block holder would invest for the long term and, over that term, monitor management's performance, encourage desirable corrections in managerial objectives and practice, and intervene before significant problems become life-threatening crises for the firm.¹⁹ Given these aspirations, it is helpful to examine the extent to which a relational investor assumes duties toward other shareholders. An investor's explicit or implicit commitment to buy and hold a significant block of a corporation's stock—the minimum defining

liability on the parent might not produce any increase in effective precautions taken against risky activity conducted by subsidiary-level agents. *See id.* at 36.

¹⁶ See Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987 (1994). As the title of his insightful article suggests, Professor Rock delineates the exploitative uses that a relational investor might make of its position. The mechanisms he suggests to control relational investing diverge in some respects from the agency-based analysis in this paper.

¹⁷ See William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1920 (1995) (defining relational investor as one who takes large undiversified positions, holds them long-term and monitors carefully, but does not interfere with formulation or implementation of business plan except in crisis); Louis Lowenstein, *Opening Remarks, Columbia University Institutional Investor Project, Conference on Relational Investing: "More Like Whom?"*, 18 J. CORP. L. 697 app. at 705-06 (1993) (offering baseline definition of relational investing that includes DuPont investment in General Motors and Warren Buffett, but excludes pension funds, insurance companies, mutual funds, and banks known to author).

¹⁸ See, e.g., Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 822-24 (1992) (advocating elimination of regulatory barriers to foster monitoring by institutional investors). To be sure, if it is difficult for most investors to generate at- (or above-) market returns by holding an undiversified portfolio, regulatory barriers by themselves may not significantly impede the expansion of relational investing. Moreover, to be successful, a relational investor must monitor and, at times, intervene. These activities are not free. The cost of engaging in them, relative to their anticipated investment return, can usefully be compared with the return anticipated from investing the same amount in a passive investment. To the extent a relational investor holds a portfolio that is not diversified against firm-specific risk, the investor has foregone the risk-reduction benefits of diversification, an investment decision that is warranted only by the anticipation of higher returns from a less diversified portfolio. In short, relational investing imposes opportunity costs as well as direct costs. *See* Thomas A. Smith, *Institutions and Entrepreneurs in American Corporate Finance*, 85 CAL. L. REV. 1, 41, 63 (1997).

¹⁹ See Bratton & McCahery, *supra* note 17.

characteristic of relational investing²⁰—creates opportunities to act in ways that may benefit other shareholders,²¹ as well as opportunities to act in ways that may not be benign. Agency and associated nonagency doctrines provide a legal framework within which to explore constraints on conduct by relational investors that does not advance the interests of all shareholders. The perspective on these matters afforded by the law of agency makes clear that, under current legal norms, large block holders are relatively free to pursue self interest without much regard for the interests of other shareholders in portfolio companies. It also suggests that enthusiasm for expansion in relational investing may overstate the likely benefits.

II. DISPROPORTIONATE ADVANTAGES

A large block holder might benefit from its investment disproportionately to other shareholders in a number of ways. Some forms of disproportionate benefit warrant Edward Rock's characterization as the "dark side" of relational investing. "Dark side" benefits encompass greenmail and commercial transactions that are unjustifiably favorable to the block holder.²² This paper examines two other types of benefits—ones not necessarily tainted by a "dark side" cast: (1) a large block holder's access to and use of nonpublic information, and (2) its purchase or sale of stock on terms not available to other investors. It is easy to imagine circumstances under which a large block holder would receive nonpublic information. Two situations that come immediately to mind are the selective transmission of information directly from management of the portfolio company to the block holder, and receipt of nonpublic information by a director of the portfolio company who is elected by or otherwise designated as a representative of the block holder. Consider, as an initial matter, the sharing of information to dissuade the block holder from selling. Fearing that the

²⁰ See Ian Ayres & Peter Cramton, *Relational Investing and Agency Theory*, 15 CARDOZO L. REV. 1033, 1034 (1994).

²¹ See *id.* at 1035. Ayres and Cramton conclude that "relational investing can reduce agency costs, both by increasing the principal's incentive to acquire information, and by improving the principal's ability to foster a monitoring reputation through a long-term relationship with the firm's management." *Id.* Additionally, relational investors have stronger incentives to detect and discipline managers who make poor use of corporate assets.

²² See Rock, *supra* note 16. A relational investor's position assumes "dark side" qualities when it enables the investor to compel dealings with the corporation on terms less attractive than those otherwise available, or when it defeats a transaction—such as a change in control—that would be beneficial to all other shareholders in exchange for benefits to the relational investor.

holder is about to jettison its investment, the management of a portfolio company might share encouraging nonpublic information with the holder. As long as the holder does not use the information as a basis for buying or selling the stock, its mere receipt of the information (and indeed its decision to hold the stock) violates no prohibition on insider trading. Such prohibitions apply only when a completed transaction follows the transmission and receipt of information.²³ They do not capture all selective releases of nonpublic information, nor do they prohibit all uses of nonpublic information. Accordingly, in this example, the block holder's use of nonpublic information provided by the corporation would enable the block holder to avoid the loss that would be suffered by less well-informed shareholders who sold the stock.²⁴

Consider next a large block holder that votes its shares to elect a representative to the portfolio company's board.²⁵ Directors obviously receive nonpublic information about the corporation; as well, their own decisions as directors often constitute material non-

²³ In this example, the large block holder has neither purchased nor sold shares. A purchase or sale of securities is a pre-requisite to a violation of Rule 10b-5 and Section 10(b) of the Securities Exchange Act. The transmission of nonpublic information by management does not constitute an illegal tip unless it is motivated by the prospect of direct or indirect personal gain for the insider who relays the tip. See *Dirks v. Securities and Exchange Comm'n*, 463 U.S. 646 (1983).

²⁴ Such sellers would not have a federal claim against the block holder because it did not sell. Any claims the sellers asserted against the corporation would be met with the defense that the information was not tipped for an improper personal purpose. To be sure, nondisclosure of information to selected shareholders constitutes federal securities fraud when it contravenes a duty of disclosure owed to the shareholder. See *Jordan v. Duff & Phelps*, 815 F.2d 429 (7th Cir. 1987). In *Jordan* a corporate officer did not reveal information to an employee-shareholder who, by contract, was obliged to resell his stock to the corporation when his employment terminated. When the employee-stockholder told the officer that he might quit, the officer knew that, if he revealed the information that merger negotiations were underway the employee would stay on because his stock would be worth more. Such causal specificity is rare in the context of a publicly-traded corporation. Moreover, the nondisclosure in *Jordan* would directly benefit the knowledgeable officer if he owned any shares in the corporation; he did not disclose the fact that the corporation was well on its way to merging with another corporation at a substantial per-share premium. The payout to the employee-shareholder if he quit immediately, however, was by contract at a lower price than the employee-shareholder would have received, thanks to the merger, had he remained for a few months longer.

²⁵ A right to board representation follows as a matter of formal entitlement if the portfolio company has cumulative voting for directors and the block in question is sufficiently large to elect at least one director. Cf. Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124 (1994) (discussing the value of cumulative voting to institutional investors). The right is formally ensured, as well, if the block consists of preferred stock with class voting rights to elect one or more directors. The right would arise more informally if the persons responsible for nominating candidates for board memberships are agreeable to the block holder's representation on the board and the other shareholders acquiesce in their judgment.

public information until the decisions are made public. An initial question is whether the law of agency automatically imputes information that the director receives to the shareholder who elected her. The common law of agency answers "no" to this question as a corollary of the principle that a director is not, as such, an agent of the corporation or its shareholders.²⁶ If, however, the director undertook to report to the block shareholder and to act as a director subject to its instructions, then the director and the shareholder appear to have an agent-principal relationship. Knowledge that the agent/director acquired within the scope of the relationship would then impute to the principal/shareholder.²⁷

Berkshire's own practices illustrate caution in this regard, heightened no doubt by its shareholding in Salomon Inc. Mr. Buffett wrote, in 1988, that Berkshire's arbitrage activity in shares of RJR-Nabisco was restricted by Salomon's participation in a bidding group when RJR was in play.²⁸ "Customarily," writes Mr. Buffett, he and Mr. Munger,²⁹ as directors of Salomon, "are walled off from information about [Salomon's] merger and acquisition

²⁶ See RESTATEMENT OF AGENCY, *supra* note 6, § 14C. *Accord* Bayne v. Jenkins, 593 S.W.2d 519, 532 (Mo. 1980) (en banc) (shareholder not chargeable with knowledge of directors' actions not directly pertaining to shareholder's interests as a shareholder).

Directors as such are not shareholders' agents because, once elected, shareholders have no right to control them. Nevertheless, legal scholars sometimes refer to directors as shareholders' agents. See, e.g., Manuel A. Utset, *Disciplining Managers: Shareholder Cooperation in the Shadow of Shareholder Competition*, 44 EMORY L.J. 71, 91 (1995). The explanation for this usage may be that directors owe fiduciary duties and are charged by statute with carrying out defined functions. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (1991).

²⁷ This point is subject to a qualification of considerable significance. Knowledge that the agent acquires while acting adversely to the principal's interests does not impute to the principal. See RESTATEMENT OF AGENCY, *supra* note 6, § 282(1). This exception is itself subject to exceptions. The principal is bound by the agent's knowledge if the agent appeared to be authorized to do the act on behalf of the principal, or if the principal knowingly retained a benefit generated through the agent's act. See *id.* § 282(2).

²⁸ Salomon made two separate sorties on the RJR-Nabisco front: (1) as an equal partner with Hanson Trust PLC for a bid that was never made, and (2) as a financial backer of the unsuccessful management-sponsored buyout bid. See BRYAN BURROUGH & JOHN HELYAR, *BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO* 197, 229, 248, 278 (1990). Mr. Buffett was consulted about Salomon's initial partnership venture and, although he supported it on the basis of the profitability of the tobacco business, he declined an invitation to participate directly. See *id.* at 218. The management-supported bid included terms highly favorable to management that Mr. Buffett reportedly opposed. See *id.* at 323.

²⁹ Charles T. Munger is Berkshire Hathaway's Vice Chairman. He and Mr. Buffett have managerial responsibility for Berkshire's entire business. See *Buffett Essays*, *supra* note 3, at 6, 29. On some questions their opinions diverge. For example, to acknowledge Mr. Munger's opposition to Berkshire's acquisition of a corporate jet, eventually named "The Indefensible," Mr. Buffett proposed naming the craft "The Charles T. Munger." See *id.* at 53 n.11.

work. We have asked that it be that way: The information would do us no good and could, in fact, occasionally inhibit Berkshire's arbitrage operations."³⁰ To be sure, although the common law of agency does not impute knowledge to a shareholder on the basis of a director's receipt of information, activities like risk arbitrage may require the shareholder to demonstrate that it did not, in fact, possess market-sensitive nonpublic information generated by a portfolio company.

Additionally, large block holders may be able to buy or sell stock on terms uniquely available to them, subject for the most part only to regulations of general applicability. Federal securities statutes do, however, contain a few provisions that are triggered by the size of a particular holding. Acquiring direct or indirect beneficial ownership of five percent or more of a class of registered equity security obliges the acquiror to file a Schedule 13D disclosure statement.³¹ Moreover, a holder of ten percent or more of a class of registered equity security is an insider for purposes of the restrictions on short-swing trading and the reporting requirements imposed by section 16 of the Securities Exchange Act.³²

Regulatory restrictions aside, a large block holder is free to sell its holding on whatever terms it finds attractive.³³ If the holder is able to sell at a premium over the market price, the seller is under no duty to assure by contract that the purchaser will offer to buy from other shareholders at the same price. Only rarely, and in factually unusual circumstances, does case law in the United States require a controlling shareholder to account to fellow shareholders for its profit from selling its holding at a premium.³⁴ Equally rare are cases that require a shareholder to compensate noncontrolling shareholders for loss following a sale of a control block to an owner under whose control the corporation declines in value.³⁵ Of course, these doctrines become applicable only when the block

³⁰ *Id.* at 71.

³¹ See Securities Exchange Act of 1934, 15 U.S.C. § 78m (1994); 17 C.F.R. § 240.13d-101 (1996).

³² See *id.* § 78p(a)-(b).

³³ Generally applicable restrictions on sale include, of course, those pertinent to unregistered securities.

³⁴ A rare exception is *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955).

³⁵ See *Harris v. Carter*, 582 A.2d 222, 223 (Del. Ch. 1990) (holding that, prior to selling a control block, the seller has a duty to investigate the prospective buyer "to ascertain that the buyer does not intend or is unlikely to plan any depredations of the corporation" when the facts would induce suspicion in a reasonably prudent person). The basis for this duty is the tort law principle that "unless privileged, each person owes a duty to those who may foreseeably be harmed by her action to take such steps as a reasonably prudent person would take in similar circumstances to avoid such harm to others." *Id.* at 234-35.

sold can be characterized as a controlling interest.³⁶ The block holder is also free to sell the stock to the portfolio corporation itself if its directors agree to repurchase the stock. If the portfolio corporation repurchases the stock, the relevant question is whether its directors' decision is protected by the business judgment doctrine. Unless the repurchase can be characterized as the product of an insufficiently informed or improperly motivated directors' deci-

The duty imposed by *Harris* to avert foreseeable harm to others has a narrow range of operation. The duty applies only to sales of control shares in circumstances that should induce suspicion. Thus, sales of noncontrolling blocks are outside the reach of *Harris*. Moreover, the duty applies only when a controlling shareholder acts by selling; *Harris* does not impose a broad duty to act so as to avert harm to other shareholders. This limit is consistent with the absence of any duty that obliges a shareholder to exercise power over the corporation's business operations or policies. See *supra* text accompanying note 13. The limit is also consistent with the distinction drawn in tort law (and elsewhere) between acts and omissions. See Kenneth W. Simons, *Deontology, Negligence, Tort & Crime*, 76 B.U. L. REV. 273, 277 (1996).

Given the narrow reach of this duty, it should come as no surprise that recent case law does not impose a broadly-cast duty to disclose information relevant to whether a particular purchaser may indulge in looting. In *Northeast General Corp. v. Wellington Advertising, Inc.*, 624 N.E.2d 129 (N.Y. 1993), the court held that a business intermediary characterized as a "finder" was not obliged to tell its client that it had information that a purchaser of the client's business had a prior track record of looting. The finder was not its client's agent or broker; it did no more than introduce the purchaser to the seller's controlling shareholder, which concluded its service. See *id.* at 4. It is curious that the court treats the finder's disclosure obligation so narrowly when, under its agreement with its client, the finder was entitled to compensation only if a deal occurred, in an amount equal to a percentage of the dollar value of the consummated transaction. See *id.* at 11 (Hancock, J., dissenting). The finder's short-term self-interest in receiving its outcome-contingent compensation may supersede its longer-term self-interest in its business reputation. Moreover, a client may not realize that the compensation structure creates the risk that the finder will introduce a prospect when it presently, or thereafter, has material adverse information about the prospect. In any event, the narrow cast of the substantive duty to avert harm in the control sale context is complemented by the narrow duty of disclosure.

To be sure, the principle applied in *Harris* is susceptible of expansion in light of facts that are compelling, albeit less appalling than those of *Harris* itself. Possibilities would include sales to parties with track records that should reasonably induce suspicion that depredations will occur that fall short of the looting in *Harris*. An intriguing question not yet addressed in case law is whether a track record of disregard for creditors' interests suffices to trigger the duty to investigate and to avoid predictable harm.

³⁶ If a shareholder controls a majority of the voting power in a corporation, no additional showing is necessary to characterize that shareholder as a controlling shareholder. See 1 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.10(a)(1) (1994). If the shareholder has less than a majority of the voting power, the dispositive question is whether the shareholder "[o]therwise exercises a controlling influence over the management or policies of the corporation, or the transaction or conduct in question, by virtue of the person's position as a shareholder." *Id.* § 1.10(a)(2). Control is presumed to exist when a person or group "has power to vote more than 25% of the equity interest in a business organization," unless another person or group has power to vote a greater percentage. *Id.* § 1.08(b). On the federal regulatory front, the Investment Company Act of 1940 defines a presumption of control at 20%, relevant to the Act's proscription of affiliate transactions. See 15 U.S.C. §§ 80a-1(9), -17(a)(2)-(3) (1994).

sion,³⁷ as waste,³⁸ or as a disproportionate defense to a hostile takeover,³⁹ the business judgment doctrine insulates the merits of the repurchase from judicial scrutiny at the behest of a shareholder.

Likewise, a large block holder may purchase on terms not generally available and, indeed, may buy securities of a type not otherwise made available by their issuer. Much like lenders, prospective block investors enjoy considerable contractual freedom in structuring, through negotiations with the portfolio company's management, the terms that will define their future relationship.⁴⁰

³⁷ The foundational Delaware authority is *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964). The dispositive question under *Cheff* is whether the directors acted for a proper corporate purpose, which would not include simply the desire to retain control. Directors who lack an adequate informational base for their decision have breached their fiduciary duty of care, and the business judgment rule does not protect their decision from judicial review. See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). If the directors were motivated by an improper purpose in repurchasing the stock, the seller may be liable as an aider and abettor of the directors' breach of fiduciary duty. The remedy would be the imposition of a constructive trust on funds received incident to the repurchase. See *Heckmann v. Ahmanson*, 214 Cal. Rptr. 177 (Ct. App. 1985).

³⁸ A claim that a particular repurchase at a price in excess of the market price constituted waste of the corporation's assets will likely fail unless the plaintiff can quantify a gross disparity between the price paid and the consideration received by the corporation in exchange. See *Grobow v. Perot*, 539 A.2d 180, 190 (Del. 1988). The applicable standard is whether "no person of ordinary, sound business judgment would deem [the value received to be] worth what the corporation has paid." *Saxe v. Brady*, 184 A.2d 602, 610 (Del. Ch. 1962).

³⁹ See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

⁴⁰ As investors, venture capital firms likewise structure the terms on which they invest on the basis of individually negotiated bargains. A principal focus of venture capital contracting is defining the circumstances and terms on which the venture capital investor may exit from its equity ownership stake. The foundational contract structuring a typical venture capital relationship is a stock purchase agreement under which investment is made as a purchase of convertible preferred stock that is redeemable (at the holder's option) and that carries liquidation and dividend preferences. See FREDERICK D. LIPMAN, *VENTURE CAPITAL AND JUNK BOND FINANCING* § 6.04, at 222-23 (1996); Curtis J. Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 NW. U. L. REV. 865 (1997). The fact that the stock is redeemable affords protection against downside risk; that it is convertible enables the provider of venture capital to participate in upside gains—in particular, those generated by an initial public offering.

Venture capital relationships encompass stockholder agreements, moreover, that typically contain covenants creating registration rights to permit the public sale of the venture capital firm's investment. See LIPMAN, *supra*, § 2.01(f), at 44-45. "Tag-along" clauses permit the venture capital investor to participate in the stock sales of founders and other major shareholders. More harshly, a "drag-along" clause permits the venture capital investor to force the founders to sell their interest, even when the founders have retained a controlling equity interest, if the venture capital investor wishes to sell. See *id.* Drag-along rights facilitate sales to third parties whose willingness to purchase is conditioned on buying all outstanding equity. A drag-along right would also permit a governance structure in which the founder retained a controlling interest effective over matters other than those related to the terminal decision to sell the corporation.

Berkshire's holding in Salomon is illustrative of a large block holder's ability to structure purchases and sales on uniquely-available terms. To save Salomon from a takeover threat in 1987, Berkshire invested \$700 million in a uniquely-structured issue of preferred stock paying a fixed annual nine percent cash dividend. In 1995, the preferred stock became convertible into Salomon common stock at a price of \$38 in tranches of \$140 million over five years and, as earlier noted, Berkshire redeemed rather than convert its preferred stock into common stock in 1995.⁴¹ Berkshire announced on September 12, 1996 that it might issue \$400 million in notes that investors could swap after three years for up to ten million Salomon common shares. Berkshire announced the prospect of exchangeable debt in the same filing that announced it would convert \$140 million in Salomon preferred stock to common stock rather than redeem for cash as it did in 1995.⁴² Each of these transactions is, of course, consistent with the terms on which Berkshire initially invested in Salomon.

III. CONTRASTS DRAWN FROM AGENCY

Legal norms do not significantly constrain a large block holder's ability to benefit disproportionately from its investment. Agency law, on the other hand, were it applicable to the relationship between the block holder and other shareholders, would impose significant constraints. Applying agency law in this novel context is, of course, a speculative enterprise, in which questions of definition and line-drawing are unavoidable. The foundational consequences of agency law are useful starting points, nonetheless.

Two basic rules of agency are of immediate pertinence, both stemming from the fiduciary character of the relationship. First, an agent may not use nonpublic information acquired during the course of or on account of the agency for its own benefit, unless the parties agree otherwise.⁴³ Second (and once again, unless the par-

⁴¹ See Raghavan, *supra* note 2. Apart from its holding of convertible preferred stock in Salomon, Berkshire also bought common shares in Salomon in 1993 and 1994.

⁴² See Linda Sandler & Anita Raghavan, *Heard on the Street: Salomon Holders Watch for a Possible Buffett-ing*, WALL ST. J., Sept. 23, 1996, at C1. Commentators characterized the debt proposal as a way to "unload shares relatively delicately," *id.*, while others saw it, in conjunction with the 1996 conversion of Salomon preferred stock into common stock, as a "wheeze . . . less damning than a straightforward sale of the firm's stock." *The Judgment of Salomon*, ECONOMIST, Sept. 21-27, 1996, at 76.

⁴³ See RESTATEMENT OF AGENCY, *supra* note 6, § 395. This foundational principle underlies the prohibition on trading in securities applicable to people in fiduciary positions who trade in securities on the basis of nonpublic information obtained through their fiduciary positions. See *United States v. O'Hagan*, 117 S. Ct. 2199, 2208 (1997).

ties agree otherwise), an agent has a duty to account to its principal for profit made by the agent in connection with transactions conducted by the agent on behalf of the principal.⁴⁴ Consider first the large block holder's use of nonpublic information—use that in the example above leads the holder to decide not to sell its stock. This use contravenes an agent's duty to its principal since the agent acquired the information in the course of the agency. The duty is, however, subject to the parties' agreement otherwise, as is the agent's duty to account for profit made incident to the agency.

Who are the parties for agency law purposes? Put differently, if a large block holder is an agent, who is (or are) its principals? If the portfolio company's other shareholders are the principals, then it is their consent or agreement that is dispositive under agency law. This facet of an agency-based structure departs markedly from the status quo because, within the corporate context, it displaces the efficacy of decisions made by the portfolio corporation's directors.⁴⁵ That is, agency rules would require shareholder consent to the block holder's receipt of profit generated by transactions undertaken for the principal who, in this structure, would be the other shareholders. How this rule might apply to large block holders turns on how one defines "profit" for this purpose and how broadly or narrowly one defines the range of the agent's activities that would be subject to the duty. If the large block holder is understood to undertake a position of influence on behalf of the other shareholders, it arguably profits in connection with its service to its principal if it ever deals with the portfolio company on non-commercial terms.⁴⁶ Indeed, agency law's disapproval of side profits would render problematic selective share repurchases at above-market prices in the absence of consent from other shareholders. A subsidiary question is whether "consent" for this purpose should be determined by a majority of the other shareholders, or whether

⁴⁴ See RESTATEMENT OF AGENCY, *supra* note 6, § 388.

⁴⁵ It is unusual under present law for a court to conclude that a duty, whether fiduciary or otherwise, runs directly between a third party and a corporation's shareholders. A rare example is *Schneider v. Lazard Freres & Co.*, 552 N.Y.S.2d 571 (App. Div. 1990). Denying the defendants' motion to dismiss, the *Schneider* court held that an investment bank owed a direct duty to shareholders when it was retained to advise a special committee of directors conducting an auction among competing bidding groups because the committee was created specifically to protect the shareholders' interests. *See id.* at 574-575.

⁴⁶ Present law, in contrast, examines the merits of dealings between a shareholder and a corporation only when the shareholder has a controlling position. *See Kahn v. Lynch Communication Systems Inc.*, 638 A.2d 1110 (Del. 1994). The applicable standard is whether the transaction was "entirely fair" to the noncontrolling shareholders. This remains the standard even when the transaction is negotiated on behalf of the controlled corporation by a well-informed committee of independent directors. *See id.*

the consent of each shareholder should be required. Should the block holder be treated as an agent of each of the other shareholders (which would suggest that unanimous individual consent would be necessary) or as the agent of the other shareholders treated as a group? If the principal is the collective group, it might agree to be bound by majority vote.

Unsurprisingly, it is also often important to determine when, within a particular relationship, such duties become applicable. The duties imposed by agency law generally do not apply prior to the formation of the agency relationship. As a consequence, an agent-to-be is not subject to fiduciary duties in connection with the agreement creating the agency, which means that the prospective agent is under no duty to disclose the terms of compensation.⁴⁷ Under this general rule, a prospective relational investor would thus be free to structure the terms of its investment, including terms that advantage it uniquely. The general rule is, however, subject to an exception that treats the agent as a fiduciary at the pre-formation stage if the parties' relationship is one of trust and confidence, such that the prospective principal relies upon the prospective agent to deal fairly.⁴⁸ In such circumstances, the agent would have a duty of fairness in arranging the terms of the relationship, which would encompass disclosure of compensation.⁴⁹ In the relational investing context, the duty to deal fairly would most likely arise when the block holder already holds a significant stake. A related question is whether to require the consent of shareholders themselves to these terms or, short of such a requirement, to require that the terms be disclosed to shareholders, even if the corporation's directors have authority to assent to the terms. Even if direct shareholder assent is not required, one might restrict the block holder's ability to extract disproportionate benefit to terms that were disclosed to shareholders.

CONCLUSION

The state of present law sketched out in this paper reflects the fact that relational investors are scarce.⁵⁰ Existing legal norms do not seem fully apposite to embody aspirations for this type of rela-

⁴⁷ See RESTATEMENT OF AGENCY, *supra* note 6, § 389 cmt. b.

⁴⁸ See *id.*; see also *id.* § 390 cmt. 3 (explaining that agent has duty to deal fairly with principal when relationship formed is itself one of "peculiar trust and confidence," such as the attorney-client relationship).

⁴⁹ See *Martin v. Heinold Commodities, Inc.*, 643 N.E.2d 734, 741 (Ill. 1994).

⁵⁰ See Lowenstein, *supra* note 17, at 704.

tionship among a large equity holder, other equity holders, the corporation, and its management. Viewed from the perspective of a large block holder itself, as well as from the perspective of the portfolio company's other shareholders, present legal norms facilitate only commitments that are relatively weak. Consider the situation from the standpoint of a block holder that carefully monitors the performance of its portfolio companies, provides sage advice when requested, and intervenes when necessary to forestall loss. All three activities impose costs on the block holder—and, ultimately, on its own shareholders—from which the portfolio company's other shareholders benefit without bearing a proportionate share of the cost. This is a quintessential example of free riding.⁵¹ As well, under present law, the block holder is under no duty to monitor,⁵² let alone to do so competently. Even when the block holder has the power to exercise operational control, it is under no legal obligation to do so. Were they shareholders' agents, block holders would have affirmative duties to act to fulfill their obligations to fellow shareholders, and, as the preceding discussion illustrates, would, as fiduciaries, be unable to extract disproportionate benefit from their position without the consent of fellow shareholders. Some block holders, unlike Berkshire, appear to have exploited their positions in troublesome ways, in particular through greenmail transactions and inter-firm transactions on terms that would be unavailable to parties in arms-length transactions.⁵³ Viewed most charitably, such holders may be attempting to offset free riding effects, so that the costs and risks that an undiversified block position represents are rewarded by an adequate return on the holder's investment.

Considerable distance thus exists between the legal regime applicable to large block holders in the status quo and the terms of a plausible, if hypothetical, relational bargain. This distance is likely to remain unless the net benefits of large block holdings can be persuasively demonstrated. Moreover, if the existence of those benefits is plausible, it is curious that shareholders have not themselves hired sophisticated investors expressly to serve as their monitoring agents. Such a direct employment relationship would eliminate free riding problems because the monitoring agent would be compensated directly for its efforts. Such a relationship would

⁵¹ See PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION AND MANAGEMENT* 499 (1992). For discussion of another form of free riding, specific to Berkshire, see *supra* note 3.

⁵² See *supra* note 35.

⁵³ See Rock, *supra* note 16.

also restrict the monitoring agent's ability to extract additional or "dark side" benefits from the relationship without its principals' consent.⁵⁴ To be sure, direct compensation structures engender controversies of their own, especially when they appear to overcompensate, since the transparency of direct compensation facilitates comparison of benefits and costs.⁵⁵

⁵⁴ Commentators suggest that a key question about relational investing is whether it generates benefits for all shareholders that exceed the private benefits that inure solely to the relational investor. See Jill E. Fisch, *Relational Investing: Will It Happen? Will It Work?*, 55 OHIO ST. L.J. 1009, 1045 (1994). The question's salience assumes that relational investors are compensated only indirectly. In contrast, a direct employment relationship typically entails compensation paid by the beneficiaries of the service to the person performing the service. This aspect of the structure of direct compensation makes it more transparent than compensation achieved indirectly through third-parties. As Professor Fisch argues, the proposition that insider trading could be an effective device for management compensation raises similar questions about the consequences of indirect compensation. See *id.* at 1046-47. When the recipient of a service does not pay for the service directly, the service may be overpriced.

⁵⁵ Consider, in this light, Mr. Buffett's recent opposition to the level of advisory fees to be paid by Gillette Co. in connection with its acquisition through merger of Duracell International, Inc. See Steven Lipin, *Adviser Fees for Duracell Rile Buffett*, WALL ST. J., Nov. 26, 1996, at C1. Berkshire Hathaway controls about 11% of Gillette's shares. Mr. Buffett, a Gillette director, abstained from voting at the board meeting when the payment of \$30 million in fees to Kohlberg Kravis Roberts & Co. (KKR) and Morgan Stanley & Co. was approved. KKR controlled Duracell through a 34% equity ownership stake and four directors on its board. In contrast, Gillette's advisors would earn \$16 million in fees for the same transaction. The stated reason why Mr. Buffett abstained was his belief that Duracell's advisory fees were excessive. See *id.* A direct or explicit compensation structure for services facilitates this sort of assessment. Indeed, the stock market's reaction to the Duracell transaction was positive: the value of Gillette's market capitalization increased by almost \$4 billion between the time the transaction was announced and the date that Mr. Buffett's abstention was publicly disclosed. See *id.*

One consequence of transparency in compensation is that it enables one to separate compensation from the benefit one realizes through a transaction or from the transaction's other economic consequences. The history of Gillette's acquisition of Duracell is instructive. Duracell's investment banking and advisory fees were disclosed to and discussed with Gillette only after the parties agreed to the principal terms of the merger in which Duracell shareholders would receive Gillette shares as compensation. See *Gillette Company, Form S-4 Registration Statement*, at 30 (filed on Nov. 25, 1996) <<http://www.sec.gov/Archives/edgar/data/41499/0000950135-96-005104>>. Duracell's fees, on a percentage basis, represented about 0.39% of the value of the transaction, a percentage within the range of acquired companies' advisory fees paid in recent large transactions. Mr. Buffett noted that pre-merger Gillette shareholders would effectively bear about 80% of the Duracell fees. Given Berkshire Hathaway's ownership of about 11% of Gillette's pre-merger equity, its "share" of Duracell's fees amounts to about \$2.64 million. Even though the Gillette board did not believe the Duracell fees to be material in the context of the merger, their transparent nature enables them to be isolated and evaluated. Mr. Buffett perhaps considered whether he, as an owner selling a business, would pay an advisory fee of comparable amount. See *id.*

However unusual such an employment relationship would be, it is legally feasible.⁵⁶ Its nonoccurrence calls into question the potential of relational investing to benefit shareholders in augmenting the present benefits they would receive if the corporation has a board of directors that includes at least a few members who are not engaged in operational management of the corporation. Although relational investing promises additional monitoring, the likely benefit over the status quo may not be compelling. Furthermore, by making an explicit or implicit commitment to hold its stock for a long time, a relational investor sacrifices the benefits of liquidity—easy exit at any time through sale into a public capital market—thereby assuming the costs of holding the functional equivalent of privately placed securities restricted from ready sale. As investors tend to value, seek, and use liquidity in publicly traded corporations, they rationally seek compensation for any enforceable commitment to forego its benefits.⁵⁷ This circumstance inevitably impedes the occurrence and attractiveness of relational investing in public corporations; it also suggests that the benefits of relational investing might not come to shareholders for free.

Two additional dimensions of Berkshire Hathaway are appropriate concluding points. Although Berkshire is often mentioned as an exemplar of relational investing,⁵⁸ its principal officers and controlling shareholders do not believe they are relational investors at all. They perceive themselves, initially, to be investing in a business to be run by others,⁵⁹ not venturing into a relationship comparable to that undertaken by an institutional lender or a venture capital firm. Indeed, Warren Buffett reports that neither he nor Charles Munger, Berkshire's Vice-Chairman, have ever used the term "relational investing" to characterize Berkshire's relationship with its portfolio companies.⁶⁰

⁵⁶ For an example of a relationship in which duties ran directly between a professional advisor and shareholders, see *supra* note 45.

⁵⁷ Relatedly, the terms on which venture capital firms invest in start-up corporations include elaborate provisions to facilitate exit. See *supra* note 40.

⁵⁸ See, e.g., John H. Matheson & Brent A. Olson, *Corporate Cooperation, Relationship Management, and the Trialogical Imperative for Corporate Law*, 78 MINN. L. REV. 1443, 1479 (1994) (commending Warren Buffett as an exemplar of a relational investor).

⁵⁹ As events evolve, the relationship may require a different structure. As a result of the massive legal, regulatory, and business problems confronted by Salomon, Inc. in 1991, Mr. Buffett, who had previously been a director, became the firm's chairman and CEO. See ROGER LOWENSTEIN, *BUFFETT: THE MAKING OF AN AMERICAN CAPITALIST* 383 (1995).

⁶⁰ See Lawrence A. Cunningham, Editor, *Conversations from the Warren Buffett Symposium*, 19 CARDOZO L. REV. 719, 743 (1997). One might wonder whether a self-described "relational investor" would incur duties to the portfolio company, its management,

An element of Berkshire's self-characterization is nonetheless intriguing, suggesting as it does the terms of a stable, agency-based relationship among shareholders. After the public offering of Berkshire Class B shares, Mr. Buffett wrote to all Berkshire shareholders that "[a]lthough our form is corporate, our attitude is partnership. Charlie Munger and I think of our shareholders as owner-partners and of ourselves as managing partners."⁶¹ This language reflects an undertaking to apply, within Berkshire itself, the agency law norms discussed above, an undertaking that would eliminate the prospect of transactions uniquely advantageous to Berkshire's controlling shareholders. An additional stabilizing force stems from Mr. Buffett's assurance in the same document: "Charlie and I cannot promise you results. But we can guarantee that your financial fortunes will move in lockstep with ours We have no interest in large salaries or options or other means of gaining an 'edge' over you."⁶² Berkshire's manifest success, and that of its controlling shareholders, demonstrate that long-term mutual gain is fully compatible with undertaking to act as a fiduciary toward fellow shareholders.

and its other shareholders. The answer under present law turns on whether self-proclamation as a "relational investor" would induce others to repose their trust and confidence, and whether such self-proclamation should be deemed an undertaking to act on behalf of others. See *supra* text accompanying note 7.

⁶¹ *Buffett Essays*, *supra* note 3, at 29.

⁶² *Buffett Essays*, *supra* note 3, at 31.